IFRS NEWSLETTER
LEASES

Issue 18, October 2015

KPMG
cutting through complexity

"The IASB is pushing to finalise its new leases standard and has selected an effective date of 2019."

Kimber Bascom,
KPMG's global IFRS leasing standards leader

PREPARING FOR 2019

This edition of *IFRS Newsletter: Leases* provides an overview of the IASB discussions of the leases project in October 2015.

In its final public meeting on the leases project, the IASB agreed on the effective date of the new standard and cleared five sweep issues identified during the drafting process.

The IASB decided that IFRS 16 *Leases* will be effective for accounting periods beginning on or after 1 January 2019. Early adoption will be permitted, provided the company has adopted IFRS 15 *Revenue from Contracts with Customers*. The IASB expects that its new leases standard will be ready for publication in December 2015.

The FASB will discuss the effective date of its version of the standard in November 2015.

Highlights

2019 effective date

- The IASB agreed on a 2019 effective date for the new leases standard.

Definition of a lease

- The Boards have devoted more discussion and outreach to the on/off-balance sheet test than to any other area of the standard. However, many stakeholders remain concerned about the new definition.

Sweep issues

- The IASB clarified the lease modification requirements and also resolved four other sweep issues arising from the external review draft process.

Are you ready for the new standard?

- What do you need to do to get ready for 2019? Our checklist asks 10 key questions to help you prepare for implementation.

CURRENT STATUS OF THE PROPOSALS

The 2013 proposals …

The Boards have been working towards a converged standard that would bring most leases on-balance sheet for lessees. This joint project was intended to replace the current lease accounting requirements under IFRS and US GAAP. In addition, there would be significant consequential amendments to IAS 40 *Investment Property*. In May 2013, the Boards published a revised exposure draft (the 2013 ED), which updated the proposals published in the 2010 exposure draft. The 2013 ED contains the following key proposals, all of which have been redeliberated by the Boards in 2014 and 2015.

Lease identification

A 'lease' would be a contract that conveys the right to use an identified asset for a period of time in exchange for consideration. The identification criteria would be based on rights to control the use of identified assets. A contract would convey these rights if the customer could both direct the use of the asset and derive substantially all of the benefits from its use. If a single contract contains multiple lease and/or non-lease components, then the company would generally be required to account separately for each component.

Lease classification

The proposals would introduce new lease classification tests, resulting in a 'dual model' for both lessees and lessors. For Type A leases – most leases in which the underlying asset is not property (i.e. not land and/or a building) – interest income/expense would be recognised, similar to finance leases today. Straight-line income/expense recognition would be preserved for Type B leases – most property leases – similar to operating leases today.

Lessee accounting

A lessee would recognise a right-of-use (ROU) asset (representing the right to use the underlying asset) and a lease liability (representing the obligation to make lease payments). The lease liability would be amortised using the effective interest rate method under both models. For Type A leases, the ROU asset would generally be amortised on a straight-line basis. However, for Type B leases the lessee would subsequently measure the ROU asset as a balancing figure to achieve a straight-line profile of total lease expense (excluding any contingent rentals) consisting of both amortisation and interest expense.

Lessor accounting

For Type A leases, the lessor would derecognise the underlying asset and recognise a lease receivable and residual asset. For Type B leases, the lessor would continue to recognise the underlying asset and recognise lease payments as income.

Short-term leases

Leases with a maximum contractual term, including renewal options, of 12 months or less would be exempt.

What's new?

The key decision this month was that the IFRS version of the new leases standard will be effective in 2019. Based on the IASB's own outreach, this date is likely to be preferred more by preparers than users of financial statements.

This marks the end of redeliberations on the proposals included in the 2013 ED. Those redeliberations have seen significant changes to the 2013 proposals – in particular:

- simplifications in many areas – including new practical expedients and transition reliefs;
- a joint decision by the Boards to abandon the lessor accounting proposals – the new standards will retain many key aspects of the current lessor accounting model; and
- disagreement over the lessee accounting model – the IFRS standard will feature a single lessee accounting model, while the US GAAP version will feature a dual model, including the Type B model in which the ROU asset is measured as a balancing figure to achieve straight-line expense.

It now seems certain that the Boards will achieve one key objective of the leases project – more leases are coming on-balance sheet for lessees. However, the new leases standard remains highly controversial.

The Boards have made significant conceptual compromises to finalise the project. These include the exception for leases of low-value items in the IFRS version of the standard, and the balancing figure lessee model in the US GAAP version of the standard.

One key application issue stands out above all others – the definition of a lease. This is the new on/off-balance sheet test. The Boards have devoted more discussion and outreach to this topic than to any other area of the standard. However, many stakeholders remain concerned about the new definition.

At the time of writing, we expect that this will be our last leases newsletter before the new standard is published. We plan an extensive range of publications and guidance to accompany the new standard, which will be available from kpmg.com/ifrs.

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A fundamental overhaul in lessee accounting from 2019.

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• No lease classification test
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– lessee would recognise a right-of-use (ROU) asset and lease liability
– treated as the purchase of an asset on a financed basis</td><td>• Dual lease accounting model
• Lease classification test based on IAS 17 Leases classification criteria
• All leases on-balance sheet:
– lessee would recognise a ROU asset and lease liability
– Type A (finance) leases treated as the purchase of an asset on a financed basis
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<tr><td>Lease term and purchase options</td><td colspan="2">• Payments for optional – e.g. renewal – periods and purchase options included in lease accounting if it is reasonably certain that the lessee will exercise those options, consistent with the high threshold in current GAAP
• Lessees to reassess renewal and purchase options if there is a significant event or change in circumstances that is within the control of the lessee – e.g. construction of significant leasehold improvements
• No reassessment of renewal and purchase options by lessors</td></tr>
<tr><td rowspan="2">Practical expedients and targeted reliefs</td><td colspan="2">• Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under the revised proposals is 12 months or less
• Portfolio-level accounting permitted if it does not differ materially from applying the requirements to individual leases</td></tr>
<tr><td>• Optional lessee exemption for small-ticket leases – i.e. leases of assets with a value of US$5,000 or less when new – even if material in aggregate</td><td>• No exemption for small-ticket leases</td></tr>
<tr><td>Effective date</td><td>• Accounting periods beginning on or after 1 January 2019
• Early adoption permitted if IFRS 15 also adopted</td><td>• To be discussed in November</td></tr>
</table>

EFFECTIVE DATE

The IASB agreed that its new leases standard will be effective in 2019.

What's the issue?

When will companies be required to apply the new leases standard?

The 2013 ED did not include a proposed effective date. Respondents to the 2013 ED that chose to comment on the effective date generally said that a significant period of time would be required between publication of the new standard and its effective date, due to the costs and complexity of applying the 2013 proposals.

Since then, the IASB believes that it has simplified its lease proposals and introduced new practical expedients and transition reliefs to ease the burden of implementation.

In the October IASB meeting, the IASB staff reported that recent outreach on the effective date found that a majority of companies:

- considered that they would need two to three years to implement the new standard following publication – though some argued for an effective date as late as 2020 or 2021; and
- would prefer to adopt the new leases standard after IFRS 15, though some wanted the option to adopt both the new revenue and leases standards at the same time.

In contrast, users of financial statements generally wanted companies to apply the IASB's new standards on financial instruments, leases and revenue at the same time – i.e. from 2018.

What's new?

At its October meeting, the IASB agreed that companies will be:

- required to apply the new standard for annual periods beginning on or after 1 January 2019; and
- permitted to early adopt, provided that they also adopt IFRS 15.

The FASB has not yet discussed the effective date of its version of the standard.

What are the implications?

Many companies will be pleased that the IASB has been influenced more by feedback from preparers than from users. However, it is clear that the closing years of this decade will see a period of major accounting change for companies. The IASB's new financial instruments and revenue standards will take effect in 2018, followed by leases one year later.

If the IASB meets its target to publish the leases standard by the end of 2015, then most companies will have three years to prepare for implementation. A key early decision will be the transition approach selected, as this will affect whether a company restates the comparatives in the first financial statements in which it applies the new leases standard. This will in turn influence the scope and timing of a company's implementation project.

Most companies will have leases in place today that will run to 2019 or later. And for many companies, 2019 will arrive all too soon. Our simple checklist on page 8 will help you begin to think about how ready you are to adopt the new leases standard.

LEASE MODIFICATIONS

The IASB clarified the lease modification requirements.

What's the issue?

When is a lease modification treated as a new lease?

The 2013 ED contained only limited guidance on lease modifications. During redeliberations, the IASB agreed to expand the guidance in this area.

The external review draft of the new standard stated that a lease modification would be treated as a *separate new lease* if:

- the lease modification increases the scope of the lease – for example, by adding the right to use one or more underlying assets, or extending the contractual lease term; and
- the consideration for the lease increases by an amount commensurate with the stand-alone price for that increase.

Reviewers were concerned about the potential difference in treatment of extensions to the term of a lease arising from:

- a lease modification – which the company would account for as a new separate lease from the date on which the new lease commences; and
- reassessment of an existing extension option – which the company would account for as a continuation of the original lease.

What's new?

At its October meeting, the IASB agreed that a lessee (and a lessor holding a finance lease) should treat a lease modification as a separate new lease *only* if:

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the increase in consideration is commensurate with the increase in scope.

What are the implications?

Many companies will welcome the introduction – for the first time in IFRS – of detailed guidance on accounting for lease modifications. This has been a significant practice issue for some years, with lease modifications becoming common in changing economic circumstances.

This decision eliminates potential inconsistencies in accounting for economically similar transactions. Lessees, and lessors that hold finance leases, would treat a lease modification that extends the lease term as the continuation of the existing lease. Therefore, any increase in lease assets and liabilities would be recognised at the date that the modified terms and conditions are agreed.

The IASB and FASB versions of the standard are now converged in this area.

OTHER SWEEP ISSUES RESOLVED

The IASB also discussed four other sweep issues, bringing public standard-setting on the leases project to a close.

What's the issue?

What other issues remain outstanding on the leases project?

The IASB staff assessed that it was only necessary for the IASB to debate five sweep issues arising from the external review draft process. In addition to lease modifications, the IASB considered the following sweep issues.

- *Reassessment of the discount rate for floating interest rate leases:* Reviewers questioned why the external review draft did not require a lessee to update the discount rate applied when lease payments are revised based on an index or rate.
- *Costs associated with returning an underlying asset at the end of a lease:* Reviewers noted that such costs were not specifically addressed in the external review draft.
- *The treatment of short-term leases and leases of low-value assets in a business combination:* Reviewers questioned whether it was necessary for an acquirer to recognise assets and liabilities for such leases if the recognition exemptions are elected.
- *Leases that are part of a disposal group that is held for sale or a discontinued operation:* Reviewers questioned whether a lessee should be required to provide the disclosures in the new leases standard for such leases.

What's new?

At its October meeting, the IASB agreed the following.

- A lessee should update the discount rate for a floating interest rate lease whenever the lease payments are updated because of a change in the interest rate used to determine those payments.
- A lessee should account for restoration obligations associated with a lease in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* – i.e. a lessee would:
  - include an initial estimate of costs to be incurred in the initial measurement of the ROU asset; and
  - account for any changes in the obligation as an adjustment to the carrying amount of the ROU asset in accordance with IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.
- The current requirement in IFRS 3 *Business Combinations* for an acquirer to recognise assets and liabilities if the terms of an operating lease in which the lessee is the acquiree are favourable or unfavourable should not be retained for short-term leases or leases of low-value assets for which the recognition exemptions are elected.
- A lessee should provide only the disclosures required by IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* for leases within the scope of that standard.

What are the implications?

These decisions clarify a number of practical requirements, including the interaction between the new leases standard and other existing IFRSs.

Most significantly, the issues discussed by the IASB in the October meeting are the only issues that the IASB considers it necessary to debate in public before publishing the new leases standard. This meeting brings to a close a long process of standard-setting that began almost ten years ago. The IASB plans no further discussions relating to the new leases standard before the standard is issued. The IASB expects that the new standard will be ready for publication in December 2015.

ARE YOU READY FOR THE NEW STANDARD?

What do you need to do to get ready for 2019?

Planning your implementation project will take time and care. However, it might be worth asking yourself a few simple questions now – just to get a feel for the scale of the challenge ahead…

Topic	Questions and comments	✔
Lease definition	**Do you know which of your transactions are, or contain, leases?**	☐
	Will you elect to grandfather the lease definition for existing contracts on transition?	☐
	• In many cases, lease definition will be obvious, and a transaction that is a lease today will be a lease in 2019. However, there are significant changes in lease definition that will affect many common transactions – e.g. power purchase agreements and transport agreements. • There is also a big decision to be made on transition – will you spend the time and cost necessary to reassess your existing transactions and thereby exclude some existing transactions from lease accounting, or grandfather existing arrangements and apply the new definition only to new arrangements?	
Lease data	**Do you have a database of all of your leases?**	☐
	Do you have the systems and processes necessary to calculate lease assets and liabilities?	☐
	Are your current disclosures of operating lease commitments complete and accurate?	☐
	• Some companies have databases that capture all of their lease data – but this isn't true for everyone. Now is the time to begin to assess whether your current systems have the information necessary to apply the new standard. • The operating lease commitments note may not always be the top priority in a busy reporting season. Now is the time to check that it includes all the leases that you will soon be bringing on-balance sheet, so that there are no surprises on transition.	
Debt covenants	**Will application of the new standard impact your debt and other covenants?**	☐
	• Many financial agreements feature covenants that are applied on a 'frozen GAAP' basis – that is, a change in accounting policy won't affect the covenant test. But this isn't true in all cases. • Given the scale of accounting change – with new standards on financial instruments, leases and revenue to be applied in 2018-19 – it's time to double-check, to identify any covenants you may wish to renegotiate before the standard becomes effective.	

Topic	Questions and comments	✔
Sale-and-leaseback transactions	**Do you understand the impact of the new standard on your sale-and-leaseback transactions?**	☐
	• Most companies and users know that the new leases standard eliminates sale-and-leaseback as an off-balance sheet proposition. • But there's more than one way in which a sale-and-leaseback can come back on-balance sheet. – If the transaction is a true sale under IFRS 15, then it comes on-balance sheet like a current sale-and-finance leaseback – i.e. with the liability measured at cost. – If the transaction is not a sale under IFRS 15, then it comes on-balance sheet as a financing under IFRS 9, which may require ongoing remeasurement at fair value through profit or loss.	
Financial ratios	**Do you understand the impact of the new standard on your financial ratios, KPIs etc?**	☐
	Will optional exemptions, such as those for short-term leases and leases of low-value items, have a material impact on your financial statements?	☐
	• Most companies and users know that the new standard brings more leases on-balance sheet, increasing gearing etc. • But what about other effects? – Detailed modelling may be required to predict the impact of the front-loaded total lease expense in moving from operating lease accounting to the ROU model. – The geography of the profit and loss account will change, as operating lease expense is replaced by depreciation / amortisation of the ROU asset and interest expense. – Will you redefine non-GAAP measures such as EBITDA to reflect the new lease model? – How will you present variable lease payments? – Do you know the impact the optional exemptions will have on your KPIs? Have you decided which ones to elect?	
Transition options	**Have you thought about how to transition to the new standard?**	☐
	• The new standard will offer a wide range of transition options, featuring many practical expedients. One key question is whether to apply the standard: – retrospectively, which may require additional cost and effort; or – as a 'big bang' on the date of initial application, which will require less historical information but may impact your trend data for many years to come.	

SUMMARY OF PREVIOUS DISCUSSIONS

<table>
<tr><th>Meeting date</th><th>Topics discussed</th><th>IFRS Newsletter</th></tr>
<tr><td>March 2014</td><td>• Lessee accounting model
• Lessor accounting model
• Lease term and purchase options
• Lessee short-term leases and small-ticket leases

Significantly, the Boards reached a non-converged solution to lessee accounting, and decided not to make significant changes to current lessor accounting under IAS 17.</td><td>Issue 14</td></tr>
<tr><td>April 2014</td><td>• Lease modifications and contract combinations
• Variable lease payments
• In-substance fixed payments
• Discount rate

Significantly, the Boards decided how to identify and account for contract modifications. In addition, the Boards reaffirmed that only variable payments that depend on an index or rate, or are in-substance fixed, should be included in the initial measurement of lease assets and liabilities; however, they reached different conclusions as to when lessees should reassess such payments.</td><td rowspan="3">Issue 15</td></tr>
<tr><td>May 2014</td><td>• Definition of a lease
• Separating lease and non-lease components
• Initial direct costs

Significantly, the Boards decided to retain the general principles from the 2013 ED supporting the definition of a lease based on the right to control the use of an identified asset. The Boards instructed the staff to provide additional guidance to clarify which decisions most significantly affect the economic benefits to be derived from the asset.</td></tr>
<tr><td>June 2014</td><td>• Sub-leases
• Lessee balance sheet presentation
• Cash flow presentation

Significantly, the Boards decided that an intermediate lessor would account for a head lease and a sub-lease as two separate contracts, unless those contracts meet the contract combination guidance.</td></tr>
<tr><td>July 2014</td><td>• Sale-and-leaseback transactions
• Lessor disclosure requirements

Significantly, the Boards reaffirmed the overall approach to sale-and-leaseback accounting, but differed on a number of important application issues. In addition, they decided to add new disclosure requirements for lessors.</td><td rowspan="2">Issue 16</td></tr>
<tr><td>October 2014</td><td>• Definition of a lease

Significantly, the Boards agreed on further clarifications to the definition of a lease, but deferred a vote on aspects of the definition on which they appeared to have different initial views.</td></tr>
</table>

<table>
<tr><th>Meeting date</th><th>Topics discussed</th><th>IFRS Newsletter</th></tr>
<tr><td>January 2015</td><td>• Disclosure
• Definition of a lease
Significantly, the Boards agreed on the overall disclosure objective, but disagreed on the detailed qualitative and quantitative information that a lessee would be required to disclose.</td><td rowspan="3">Issue 17</td></tr>
<tr><td>February 2015</td><td>• Leases of small assets
• Transition
• Definition of a lease
Significantly, the Boards agreed on a converged definition of a lease, while the IASB confirmed that its version of the standard would include an exemption for leases of small assets, an exemption that the FASB rejected.</td></tr>
<tr><td>March 2015</td><td>• Permission to ballot
Significantly, the Boards instructed their staff to prepare ballot versions of their respective lease accounting standards, with no further discussion of the issues on which the Boards disagreed.</td></tr>
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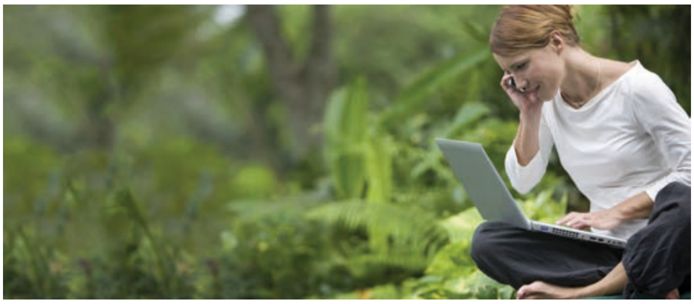

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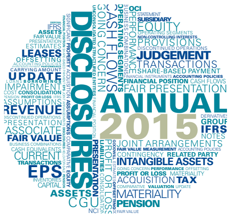

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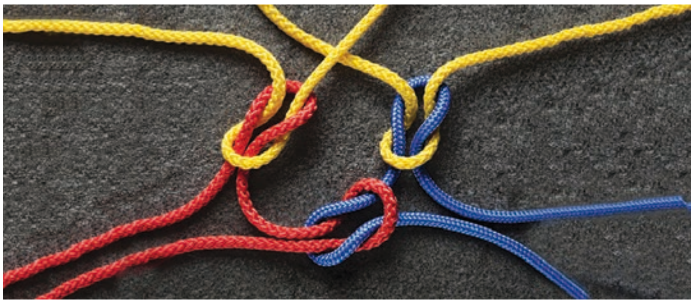

Business combinations and consolidation

Presentation and disclosures

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If you would like further information on any of the matters discussed in this *IFRS Newsletter: Leases*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.